DOCUMENT RESUME

ED 404 728 EA 028 223

AUTHOR Rossmiller, Richard A.
TITLE The Flat Tax: Implications for Financing Public Schools.
INSTITUTION American Association of School Administrators, Arlington, Va.
REPORT NO ISBN-0-87652-226-6
PUB DATE 96
NOTE 30p.
AVAILABLE FROM American Association of School Administrators, 1801 North Moore Street, Arlington, VA 22209; world wide web: http://www.aasa.org (Stock No. 587).
PUB TYPE Viewpoints (Opinion/Position Papers, Essays, etc.) (120)

EDRS PRICE MF01/PC02 Plus Postage.
DESCRIPTORS Educational Economics; *Educational Finance; Elementary Secondary Education; *Federal Government; *Public Schools; School Support; *Tax Allocation; *Tax Effort
IDENTIFIERS *Flat Rate Income Tax

ABSTRACT

The campaign for the 1996 Republican presidential election focused attention on proposals to replace the current federal income tax system with a flat tax. This booklet examines the ramifications of a flat tax for local school funding. Section 1 outlines the criteria for evaluating proposed taxes and the purposes of tax systems. The second section offers a brief history of federal income taxes, explains the current federal income tax and criticisms of it, and outlines four alternatives to the federal income tax system. The third section evaluates three flat-tax proposals: the Hall and Rabushka proposal, the Armey-Shelby proposal, and the Forbes proposal. The booklet next reviews arguments for and against the flat tax and examines implications of the flat tax for school finance. The flat tax would have a direct impact on federal funds that schools now receive. The flat tax would have less obvious effects on state revenue, school district bonds, property tax increases, interest rates and property values, attitudes toward home ownership, local school foundations, and investment in human capital. For example, if all investments in schooling are given the same tax treatment as investments in physical capital, private schools could become much more attractive because tuition payments could immediately be written off as an investment. One table is included. (Contains 14 references.) (LMI)

****
* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *
****

American Association of School Administrators

ED 404 728

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)

☑ This document has been reproduced as received from the person or organization originating it.

☐ Minor changes have been made to improve reproduction quality.

• Points of view or opinions stated in this document do not necessarily represent official OERI position or policy.

—THE—

FLAT TAXs

Implications for Financing Public Schools

AASA

BEST COPY AVAILABLE

"PERMISSION TO REPRODUCE THIS MATERIAL HAS BEEN GRANTED BY

W. Henry

TO THE EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)."

EA 028 223

The mission of the American Association of School Administrators is to achieve the highest quality of public education through effective school system leadership, with emphasis on superintendents.

About the Author: Richard A. Rossmiller is professor emeritus of educational administration in the Department of Educational Administration at the University of Wisconsin—Madison.

Nothing in this publication is to be taken as the official policy of the American Association of School Administrators. Rather, it is a document provided as a service to AASA members.

Copyright ©1996, American Association of School Administrators
ISBN 0-87652-226-6

AASA Stock No. 387

Additional copies of this and other publications can be ordered by calling AASA's Distribution Center at 1-888-PUB-AASA or 1-888-782-2272

FOREWORD

Before 1996, not many of us had paid close attention to or possibly even heard of a "flat tax" on federal income. And if we'd heard of it, we may not have been able to describe what it was, because it had never been a matter of serious consideration by Congress or by a president. With the arrival of Steve Forbes on the political landscape in the 1996 New Hampshire primary, the flat tax came into its own as a national issue. Forbes elevated the concept of a flat tax to the Republican presidential primary debates. While, in the end, he did not have the broad appeal necessary to remain a viable candidate in 1996, Forbes did succeed in having us all take notice of his one hard-held idea: the flat tax.

As we at AASA watched this picture unfold, we asked ourselves, "What impact would a flat tax and its total restructuring of the federal income tax have on local school finance? Will this continue as a issue in the general election? Will it appear as a bill under serious consideration in Congress?" The result of our questions led to this publication.

We invite you to read this information and share it with your board, because, in the end, we do believe any emergence of a federal flat tax will have an impact on schools. It is our duty as educational leaders to be well informed on this topic.

— *Paul D. Houston,*
Executive Director
AASA

CONTENTS

Foreword i

Preface 1

Evaluating Taxes 2

A Little History on Federal Income Taxes 4

The Current Federal Income Tax 4

The Flat Tax: Three Proposals 8

Arguments for the Flat Tax 12

Arguments Against the Flat Tax 14

Implications for School Finance 16

Conclusion 21

References 22

PREFACE

The campaign for the 1996 Republican presidential nomination, especially the ideas advanced by Steve Forbes, focused attention on proposals that the current federal income tax system be replaced by a flat tax. Although flat tax proposals have become part of the national political debate only recently, proposals for a flat tax on income are not new. Conservative economist Milton Friedman made a case for a flat tax *Capitalism and Freedom* (1962), and Robert Hall and Alvin Rabushka first introduced their flat tax plan in 1981.

The major elements of the flat tax involve:

- a single rate of tax to be paid on all personal and business income;
- a generous personal allowance for low-income taxpayers (but with no provision for itemized deductions); and
- exemption from taxation of capital gains, dividends, and interest received by individuals in accordance with a principle that income should be taxed only once.

School administrators and others might think that federal government adoption of a flat tax on income could have little effect on school finance because the federal government contributes only a tiny portion of the revenue that finances public elementary and secondary schools. In reality, a flat tax would have important ramifications for local school funding. For example, because many states use federal-adjusted gross income as a point of departure for calculating state income tax, any change in the federal definition of adjusted-gross income could affect state revenue flows from which state aid is paid. In addition, local property values could be affected because interest would no longer be subject to the income tax and local property taxes and mortgage interest paid would no longer be itemized deductions. Also, because bond interest would not be taxed as income, school district bonds would no longer enjoy a tax advantage. Clearly, adoption of a flat tax on income could present serious implications for local school funding.

This publication offers a brief review of the current federal income tax and the purposes it serves; outlines three major flat tax proposals and the arguments for and against each; and discusses some implications for financing education inherent in the flat tax proposals.

Evaluating Taxes

Economists and public policy mavens have over the years suggested criteria for evaluating taxes. Adam Smith, the father of modern economics, proposed four criteria against which taxes should be evaluated in his treatise *The Wealth of Nations*, originally published in 1776. Smith's four criteria—equality, certainty, convenience of payment, and economy in collection—have stood the test of time.

Tax breaks provide government subsidies...[that] do not show up as appropriations.

With regard to equality, Smith observed that people should contribute money toward the support of government in proportion to the revenue they enjoy. Concerning certainty, Smith believed that the tax should be certain and not arbitrary—that the time of payment, the manner of payment, and the amount to be paid ought to be clear to everyone. Convenience of payment, according to Smith, meant every tax should be levied at the time or in the manner most likely to be convenient for the taxpayer. Finally, Smith said that the cost of collecting the tax should be minimal to both the government and the taxpayer.

The 1996 report of the National Commission on Economic Growth and Tax Reform (also known as the Kemp Commission) set forth six principles for evaluating tax proposals.

According to the Commission, a proposed tax should:

- encourage and facilitate **economic growth.**
- be **fair,** providing equal treatment to all taxpayers.
- be **simple,** and should minimize reporting requirements.
- be **neutral,** with no incentives or disincentives for various economic activities.
- be **visible,** that is, the tax burden imposed upon every taxpayer should be easily evident to all.
- be **stable,** that is, it should be a reliable source of revenue and should not be subject to frequent changes in either the base or the rate of the tax.

Many other lists of criteria to be met by proposed taxes exist. However, it is important to recognize that regardless of the criteria applied, a decision about whether a particular tax meets the criteria is primarily a value judgment reflecting the individual tastes and preferences of the observer.

Why Impose Taxes?

Systems of taxation in nearly all developed countries serve three somewhat contradictory purposes. First, they raise revenue to support public services. Second, they redistribute income from those with more to those with less. Third, they give preferential treatment (or tax breaks) to worthy (or politically popular) causes.

Raising revenue and giving tax breaks are clearly incompatible. The more tax breaks that are given, the less revenue a tax system will produce. Tax breaks provide government subsidies—often described as "tax expenditures"—to certain groups or classes of taxpayers, but these subsidies do not show up as appropriations. In effect, they are hidden and the exact amount of the subsidy is rarely known. Such subsidies result in a proliferation of lobbying activity as special interest groups seek to influence legislators in the hope of securing preferential tax treatment for themselves.

A Little History on Federal Income Taxes

The first American income tax was enacted in 1861 to help finance the Civil War. It provided a $600 personal exemption, a 3 percent tax rate on incomes below $10,000, and a 5 percent tax rate on incomes above $10,000. The tax was allowed to lapse in 1872 and, when Congress attempted to reinstate a 2 percent tax on incomes over $4,000, it was declared unconstitutional by the U.S. Supreme Court in 1894. The Court ruled that such a tax violated Article I, Section II, Paragraph III of the Constitution, which states that all direct taxes must be levied among the states in proportion to their population.

In 1913, the 16th Amendment was ratified, authorizing Congress to tax incomes "from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." Congress then enacted a federal income tax providing a $3,000 exemption for single persons and $4,000 for married persons, with the tax rate beginning at 1 percent on the first $20,000 of taxable income and rising to a top rate of 7 percent on taxable income over $500,000.

World War I resulted in substantial changes by reducing the large exemptions for single persons and married couples, raising the bottom rate from 1 percent to 6 percent, and raising the top rate from 7 percent to 77 percent of taxable income over $1 million.

The federal income tax has seen many changes since its adoption in 1913, with increases and decreases in rates, increases and decreases in standard exemptions, the provision of privileged treatment to certain expenditures such as home mortgages, state and local taxes, and contributions to charitable organizations.

The Current Federal Income Tax

What Is Taxed?

The federal income tax is a tax on all income including wages and salaries, dividends and interest, business income, capital gains, distributions from IRAs, pensions, annuities, rental income, royalties, income from trusts, farm income, unemployment compensation, and a portion of social security benefits.

BEST COPY AVAILABLE

For 1995, the federal income tax used a set of five graduated tax rates beginning at 15 percent for taxable income up to $23,350; 28 percent on income between $23,350 and $56,550; 31 percent on income between $56,550 and $117,950; 36 percent on income between $117,950 and $256,500; and 39.6 percent on income above $256,500. A standard deduction of from $3,900 for single taxpayers to $6,550 for married taxpayers filing jointly was provided, as well as a deduction of $2,500 for each dependent. Thus, the standard deduction for a household comprised of a father, mother and two dependent children was $11,550. Taxpayers could itemize deductions to reduce their taxable income in the event their medical and dental expenses, state and local taxes, interest paid for home mortgages or investments, gifts to charitable organizations, casualty and theft losses, and miscellaneous expenses totalled more than the standard deduction. However, for high-income taxpayers the deduction was phased out as total taxable income rose.

The net income of corporations also were taxed beginning at a 15 percent rate on the first $50,000 of taxable income, going to 25 percent on the next $25,000, and 34 percent on income over $75,000. Computation of the net income of a corporation is a complicated procedure involving depreciation of capital investments and expenditures for wages, pension contributions, goods and services purchased, interest paid, and other special provisions.

Criticisms of the Federal Income Tax System

One common complaint about the federal income tax is its **complexity**. This is perhaps inevitable as Congress enacts legislation amending existing tax laws or adding to the body of tax legislation. The forms and instructions for 1995 Form 1040 include estimates of the preparation time for the various forms and schedules used by taxpayers. The Internal Revenue Service estimated, for example, that the average time required to complete Form 1040 was nearly 12 hours; that Schedule A would require about 4 1/2 hours; Schedule B would require nearly 1 1/2 hours; Schedule C would require over 10 hours; Schedule D would require nearly 4 hours; and Schedule E would require nearly 6 hours to complete. (These estimates do not include the time required to maintain the financial records necessary to complete the various tax forms and schedules.) West Publishing Company published the *1994 Internal Revenue Code* in two volumes totalling 1,378 printed pages. The accompanying *Federal Tax Regulations 1994* contained 6,439 pages that applied to the income tax.

A second major criticism closely related to the complexity of the tax is the high **cost of compliance** incurred by taxpayers in completing their tax returns. Hall and Rabushka (1995) estimate that the compliance costs for individual taxpayers in 1993 amounted to about $50 billion, a relatively conservative estimate in view of the fact that Arthur D. Little, Inc., (1988) estimated compliance costs in 1985 of $31 billion for individuals and $102 billion for businesses.

In addition to the direct compliance costs, indirect costs also create disincentives to economic growth. Although these indirect costs are difficult to quantify, economists generally agree that large disincentive costs associated with the federal income tax system discourage additional output. For example, businesses may be unwilling to expand and entrepreneurs may be unwilling to risk their capital because of high marginal tax rates and taxes on capital gains. Investors may prefer a tax shelter to a potentially more productive but riskier investment. And because interest is a deductible expense, firms have an incentive to borrow rather than issue equity because returns on equity are double taxed, once to the corporation and again when they are paid out as dividends to investors. Taken together, these and other disincentives can discourage economic growth.

A third criticism is that high marginal rates of taxation encourage **tax evasion.** The Internal Revenue Service estimates that over $100 billion was lost through tax evasion in the late 1980s. The General Accounting Office estimates that tax evasion cost the government $127 billion in 1992. The main sources of cheating are under-reporting income and overstating deductions, which together account for over 85 percent of tax evasion.

Another criticism of the federal income tax is that it encourages **tax avoidance** by permitting taxpayers to take advantage of every technicality to keep their taxes as low as possible. Technicalities include such mechanisms as loopholes, tax shelters, tax credits, exemptions, deductions, and depreciation allowances. The term **tax expenditure** is used to describe the amount of revenue that would have been collected if specific items were not exempt from taxation. These include such popular tax avoidance mechanisms as the deduction of local and state taxes and home mortgage interest and gifts of appreciated stock to charities. Tax expenditures amount to more than $500 billion annually. As the top marginal tax rate increases, tax shelters become more valuable to high-income taxpayers. In addition, devising ways to shelter income from taxation has become a major industry that includes tax lawyers, accountants, and those who sell tax-advantaged investments.

Yet another criticism of the current tax structure is that the corporate income tax, in conjunction with the individual income tax, results in **double taxation** of income. Corporations pay taxes on their business profits and when they pay dividends to their stockholders, the stockholders pay a tax on the dividends. Some economists believe that this double taxation of corporate profits impedes economic growth and capital formation because it discourages investment in risky but promising enterprises by investors and entrepreneurs.

Some critics of the federal income tax argue that the current rate structure in which marginal tax rates increase as individuals' incomes increase is a disincentive to working harder and earning additional income. These critics believe that many people would "rather go fishing" than earn more income and thus pay more taxes. It is argued that the disincentive to earning additional income, together with the double taxation of income from investments, penalizes economic growth.

Others argue that the federal income tax system is a politician's dream—but a taxpayer's nightmare. Critics argue that the current income tax system rewards politically powerful interests, especially those who can employ high-powered lobbyists to represent them. It is relatively easy to favor special interests with exemptions, loopholes, and tax shelters. Thus, it is claimed, the current income tax violates the criterion of neutrality because it applies different tax rates to different activities, favors consumption over saving, discourages investment, and discourages effort because of the high marginal tax rates on high incomes.

Four Alternatives to the Federal Income Tax System

Critics of the current federal income tax argue for taxing consumption rather than income. One way to tax consumption is with a **retail sales tax.** Such a tax, however, is relatively easy to evade by bypassing the retailer. This would be especially true of any attempt to tax services.

A second alternative widely used in Western Europe is a **value-added tax.** This tax is on all businesses and is based on the increase in the value of a product that is added by each business in the production cycle. The value added is the difference between the purchase price of the item and the price for which it is sold. It is similar to a general sales tax but has the advantage (for auditing and enforcement purposes) that each transaction is reported by two different parties (a wholesaler's revenues are a retailer's costs). One major drawback of both the retail sales tax and the value-added tax is that they weigh heavily on the poor.

A third alternative is to tax **consumed income.** This alternative is essentially an income tax that exempts savings. A taxpayer would compute total income from wages, salaries, dividends, interest, and so on, and deduct from this total any new net savings (e.g., additions to bank accounts, purchases of shares, or purchases of bonds, etc.).

A fourth way to tax consumption is through a **flat tax** on the income of households and businesses. A flat tax combines the consumed income tax levied on consumption at the household level, a value-added tax levied on consumption at the business level because income from employment (wages and salaries) is taxed at the level of the individual taxpayer and income from businesses is taxed at its source, the business.

The Flat Tax: Three Proposals

The Hall and Rabushka Proposal

All proposals for a flat tax that have drawn attention in recent months are variants of the flat tax schema originally proposed by Robert Hall and Alvin Rabushka in 1995. These Stanford professors proposed that all income be classified as either business income or personal income (including wages, salaries, and retirement benefits). A 19 percent rate levied on both business and personal income in 1993 would, according to their calculations, have provided revenue equal to that produced by the existing federal tax system in 1993.

> The base for the business tax would be computed as follows:
>
> **Total revenue from sales of goods and services**
> *less*
> **purchases of inputs from other firms**
> *less*
> **wages, salaries, and pensions paid to workers**
> *less*
> **purchases of plant and equipment (Hall and Rabushka 1995, pp. 55-56).**

Hall and Rabushka describe their proposed business tax as a "... giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages but to tax it only once. The business tax does not have deductions for interest payments, dividends, or any other type of payment to the owners of the business. As a result, all income that people receive from business activity has already been taxed (p. 61)."

Hall and Rabushka would discard all of the complicated depreciation schedules that exist and treat the total amount of any investment as an expense in the year it is made. No distinction would be drawn between an investment and a current expense. The returns to investment, that is, the profits generated by the investment, would be taxed at the 19 percent rate. Capital gains would be taxed under the business tax rather than as personal income. Thus, double taxation of capital gains and corporate earnings would be eliminated.

The second component of the system is a tax paid by households or individuals. The tax would be 19 percent of wage, salary, and pension income in excess of a generous personal allowance. The personal allowance makes it possible to avoid taxing low-income individuals or households and thus makes the overall system progressive. The personal allowance for a married couple filing jointly would be $16,300, the allowance for a single individual would be $9,500, and a personal allowance of $4,300 for each dependent would be provided. Only income above the personal allowance would be taxed at the 19 percent rate.

Hall and Rabushka recognize that special transition provisions for items such as deductions for depreciation and interest may be necessary. Furthermore, they believe that such transition arrangements will probably require a somewhat higher tax rate until existing obligations have been honored.

The Armey-Shelby Proposal

Congressman Dick Armey (R-Texas), Majority Leader in the House of Representatives, and Senator Richard Shelby (R-Alabama) introduced a flat tax plan in the 104th Congress. Their plan is embodied in HR 2060 in the House and in S1050 in the Senate. They proposed a flat tax of 17 percent on business and personal income. Like the Hall and Rabushka proposal, this proposal states that the tax on wages, salaries, and pensions would be paid by the individual recipients and all other income would be taxed at the business level. Businesses would pay a tax of 17 percent on the difference (if positive) between their revenues and expenditures.

A fourth way to tax consumption is through a flat use tax on the income of households and businesses.

Armey and Shelby propose a rather generous personal allowance of $11,350 for a single taxpayer, $22,700 for a married couple filing jointly, and $5,300 for each dependent when their system is fully phased in. Their proposal includes a phase-in period by setting a tax rate of 20 percent in the first year after enactment of their plan, which would be lowered to 17 percent in the third year. To discourage a future Congress from raising taxes they would require a 60 percent super majority vote of both the House and Senate to raise the tax rate, create multiple tax rates, lower the family allowance, or add loop-holes to the tax system. The flat tax they propose is very similar to the Hall-Rabushka proposal with the primary differences reflected in the rate of the tax and the amount of the personal allowances.

Congressman Mark Souder (R-Indiana) and others introduced a similar proposal, HR 1780, with a rate of 20 percent on both individual and business income with a personal allowance of $16,500 for a married couple filing jointly, $9,500 for an individual, and $4,300 for each dependent.

The Forbes Proposal

A proposal for a flat tax was a key element of Steve Forbes' campaign for the Republican presidential nomination. His proposed flat tax plan was similar to the Hall and Rabushka and Armey-Shelby proposals with a rate of 17 percent on both business and individual income. However, the personal allowances were somewhat higher with a standard deduction of $13,000 for each adult and $5,000 per child. Under this proposal, a family of four would have no tax obligation until its income exceeded $36,000; all income above $36,000 would be taxed at a flat rate of 17 percent.

Table 1 shows how much tax a married couple with two dependent children would pay at various family income levels under these three plans. It also shows the percent of the family's total income that would be taken by the flat tax. *Note that a 2 percent difference in the tax rate makes a substantial difference in the amount of income taken by the tax.* Clearly, the amount of personal allowance given also has a substantial effect on the amount of tax paid by a family. Also evident is that a flat tax with a generous personal allowance is a mildly progressive tax. That is, the percentage of family income taken by the tax increases as total family income increases. The larger the personal allowance, the more progressive the flat tax.

Table 1
The Effect of Three Flat Tax Proposals on the Tax Paid by a Married Couple with two Dependents

Tax Rate	Hall and Rabushka 19%	Armey-Shelby 17%	Forbes 17%
Personal Allowance	$ 25,500	$ 33,300	$ 36,000
Family Income = $25,000			
Tax	0	0	0
Family Income = $50,000			
Tax family	$ 4,655	$ 2,839	$ 2,380
% of income	9.31	5.68	4.76
Family Income = $100,000			
Tax family	$ 14,155	$ 11,339	$ 10,880
% of income	14.16	11.34	10.88
Family Income = $200,000			
Tax family	$ 33,155	$ 28,339	$ 27,880
% of income	16.58	14.17	13.94
Family Income = $500,000			
Tax family	$ 90,155	$ 79,339	$ 78,880
% of income	18.03	15.87	15.78
Family Income = $1,000,000			
Tax family	$185,155	$164,339	$163,880
% of income	18.52	16.43	16.39

Arguments for the Flat Tax

In truth, little hard evidence exists to support the arguments either for or against the flat tax. Rather, advocates and opponents base their arguments on simulations with varying assumptions as to how a flat tax would affect individual taxpayers and businesses. As is the case with most public policy issues, the arguments for and against the flat tax are based on hope and conjecture, not on solid empirical evidence. Nonetheless, these arguments are worth reviewing.

Economic Growth

Flat tax advocates argue that this approach to taxation will greatly stimulate economic growth, leading to greater prosperity and higher incomes for virtually everyone. There are two facets to this argument. The first argues that because the flat tax eliminates taxes on investment earnings and allows companies to immediately write off investments in plant and equipment it will boost labor productivity and encourage faster economic growth. The second argues that the flat tax will encourage growth by lowering tax rates and enabling workers to keep more of what they earn; therefore, they will work harder and more work will produce more economic growth.

Although most economists agree that a flat tax on income would encourage economic growth, their estimates vary widely. Optimists project 5-7 percent additional economic growth over 7 years. More conservative estimates expect only 1-3 percent of additional growth over that same time. How much economic growth might be attained is an important factor in evaluating the flat tax because advocates argue that the additional economic growth produced by the flat tax will create more income to tax, thereby filling the revenue gap created by low tax rates.

Simplification

Flat tax advocates argue that a flat tax will greatly simplify the federal tax system and reduce the cost of compliance. Hall and Rabushka (1995), for example, claim that most personal and business income tax returns could be submitted on a postcard rather than the pages of forms and schedules required by the current federal income tax. They estimate that as many as a half-million people—tax lawyers, accountants, brokers, and financial analysts—earn part or all of their living by helping taxpayers cope with the income tax code and regulations.

Double Taxation

Flat tax enthusiasts argue that the bias against savings that exists in the current federal income tax system would be eliminated because double taxation of income from savings and investments would no longer exist. They point out that dividends to shareholders would be tax free because business income would be taxed only once. Similarly, money placed in savings would not be taxed and the flow of income resulting from savings and investments would be taxed by the business tax, not the personal tax.

Evasion/Avoidance

Another argument advanced by flat tax advocates is that tax evasion and tax avoidance will be reduced. They claim that people would have far less incentive to avoid or evade taxes if the tax rate were low and constant. Also, because all income would be taxed at the same rate at either the business or the individual level, the incentive to discover ways to legally shield income from taxation would be eliminated or at least greatly reduced. Flat tax proponents argue that tax-sheltered investments, together with the high marginal rates of taxation, distort investment decisions and result in inefficient use of capital. That is, investors may prefer tax-sheltered opportunities over investments where their returns are subject to high rates of taxation.

Interest Rates

Advocates for the flat tax claim that interest rates would be lowered substantially if the flat tax were adopted. The current federal income tax permits interest payments to be deducted from income while interest earned is subject to taxation. The flat tax would not permit a deduction for interest paid and would place no tax on interest received. Hall and Rabushka (1995) argue that borrowers would no longer tolerate high interest rates if their interest payments were not deductible, and that lenders would willingly accept lower interest rates because they would no longer be taxed on the interest they receive. They estimate that interest rates could fall to 75 percent of present levels under their flat tax proposal.

Lobbying

Another claim made by advocates of the flat tax is that the lobbyists who strive to obtain favorable tax treatment for special-interest groups through exemptions and loopholes would be forced to change the focus of their efforts. The current federal tax system is rife with provisions that give preferential treatment to particular groups of taxpayers. For example, the interest from municipal bonds is not taxed at the federal level, making them particularly attractive to high-income investors; the tax on income placed in tax-sheltered annuities is deferred until the money is withdrawn; and interest

paid on home mortgages and property taxes paid by homeowners may be claimed as itemized deductions, making them attractive to homeowners. If all consumption is taxed at the same low rate, special-interest groups would no longer have an incentive to hire lobbyists (assuming, of course, that loopholes and shelters could be kept out of the tax code).

Equity/Fairness

A final argument deals with what constitutes fairness or equity in taxation. Advocates for the flat tax argue that fairness in taxation means treating everyone the same, and that taxing consumption at the same rate for everyone will achieve greater fairness in the federal tax system. As noted previously, the federal income tax has five levels with the marginal rate of the tax increasing as the taxpayer's income increases. This system of increasing marginal rates is justified by asserting that the value to the taxpayer of additional income decreases as income increases, that is, money has decreasing marginal utility. In fact, it has never been proven that money has decreasing marginal utility; the current rate structure represents a value judgment about what is "fair." Because of the plethora of loopholes, shelters, and exemptions, few taxpayers pay at the specified marginal rate on *all* of their income. Thus, the present federal income tax system is a "taxpayer's nightmare and politician's delight" because it enables politicians to cater to special-interest groups who, in turn, assist them in their campaigns for re-election.

Arguments Against the Flat Tax

At least as many critics of the flat tax exist as advocates. As is true of the advocates, critics of the flat tax base their arguments primarily on philosophical views and assumptions concerning its effects because practically no hard data can be found concerning how such a tax would actually affect taxpayer decisions or the economy.

Revenue Shortage

One criticism of the flat tax is that it would yield insufficient tax revenue, resulting in a shortage of as much as $200 billion annually. The critics argue that to generate enough revenue to match that produced by the current federal income tax system would require higher rates for the flat tax than have been proposed, which would result in a substantial increase in taxes paid by the middle class. As noted earlier, most economists agree that a flat tax would increase economic growth but they differ substantially on how large the effect would be. Critics suggest that a modest increase of 1 percent or 2 percent is all that could be expected.

Middle-Income Tax Burden

Another criticism leveled by critics of the flat tax is that it would result in a substantial increase in income taxes paid by the middle class. One criteria used by Hall and Rabushka is that the tax should reduce the burden on low-income households. Consequently, they propose a generous personal allowance considerably larger than the personal exemptions provided under the current tax system. The proposals by Armey and Shelby and by Forbes provide even more generous personal allowances than those proposed by Hall and Rabushka.

Clearly, these flat tax proposals would result in large numbers of low-income taxpayers being exempt from the tax. With regard to high-income taxpayers, the effect is much less clear because of the availability of tax shelters, loopholes, and exemptions under the current tax system. Few high-income taxpayers have a great deal of income taxed at the highest marginal rate. According to the U.S. Treasury, American families who rank in the top 20 percent on income earn 55 percent of the nation's income and pay 61 percent of the total federal tax burden. Families who rank in the top 1 percent of income receive 14 percent of all income and pay 17 percent of all federal taxes. Whether high-income families would enjoy lower effective tax rates under the flat tax is a matter of conjecture. It does appear, however, that middle-income taxpayers who enjoy some advantages under the current system might pay a slightly higher effective tax rate if a flat tax were adopted, especially if a rate of much over 20 percent were required to produce sufficient revenue.

The level of tax rates under the current federal income tax system has little effect on the percent of personal income that is paid in taxes (Reynolds 1996). Since 1951, the individual income tax has consistently collected from 9 to 11 percent of personal income regardless of the tax rates in effect. Individual income tax rates were increased in 1990 and again in 1993, but the share of personal income taken by the tax dropped from 10.1 percent in 1988 to 9.3 percent in 1993. Conversely, when the highest tax rate was reduced from 70 percent in 1981 to 28 percent in 1989, there was little change in the percentage of personal income claimed by the federal income tax and no decline in federal tax revenue. Apparently American taxpayers as a group are reluctant to give more than 10 percent of their personal income to the federal government regardless of the tax rates that are in effect.

Charitable Giving

Critics of the flat tax claim that it would discourage charitable giving by eliminating the tax deduction currently available for this item. Hall and Rabushka (1995) admit that initially a slight decline in giving for charitable causes would occur but they expect that as the economy begins to grow more rapidly, such giving will recover and will likely exceed current levels. They also note that in 1991 total cash contributions to charitable causes were about $117 billion but only $61 billion was claimed as a deduction on personal tax returns.

Effect on Housing

Critics of the flat tax argue that the tax will devalue housing and make home ownership less attractive. This criticism is related to the loss of the home mortgage interest deduction and property tax deduction under a flat tax. Critics claim that this will depress housing values and will be especially harmful to the middle class. They point to a DRI-McGraw Hill study done for the National Association of Realtors in early 1996 that predicts a 15 percent decline in home values and an increase in foreclosure rates. Flat tax advocates respond that lower interest rates will make housing more affordable and thus balance off the loss of deductions for home mortgage interest and local taxes.

Data from the Internal Revenue Service for 1993 indicate that only 23.7 percent of all individual income tax returns showed a deduction for home mortgage interest and that these deductions totalled $188.6 billion. Clearly, loss of the deduction for home mortgage interest would penalize current homeowners who are paying off their mortgages. Hall and Rabushka (1995) deal with this problem by proposing a transition period during which current homeowners would be allowed to deduct 90 percent of their mortgage interest payments until the mortgage was paid off.

Implications for School Finance

Of the total revenue available for public elementary and secondary schools in 1992-93, only 6.9 percent was from federal sources. At first glance school administrators might well conclude that the debate about the flat tax is only of academic interest and that adoption of a flat tax on income would have little effect on public school funding. A closer look, however, reveals several implications for the financing of public elementary and secondary education. One implication is immediately evident; the others are not as apparent but may be even more important.

Federal Funds

The only direct impact a flat tax might have on education funding is on the federal funds that school districts now receive. Although funds provided by the federal government provide only a small percentage of the revenue received by public elementary and secondary schools, they are an important source of revenue for programs serving children with special needs or disabilities. During the federal budget debates of 1995-96, several federal school aid programs were threatened with elimination or severe funding cuts. Loss of these funds would be a serious blow to school districts with high concentrations of special needs students. These districts typically have relatively low tax bases and would be hard pressed to make up for any loss of federal funds. If a federal flat tax on income were adopted and failed to produce as much revenue as the current tax system does, federal funds going to elementary and secondary education might well be targeted for cuts or elimination.

State Revenue

For the United States as a whole, the states provided nearly 46 percent of the revenue for public schools in 1992-93 (National Center for Education Statistics, 1995). While the sources of state revenue vary considerably from one state to another, in 1993 the general sales tax provided 32.8 percent of all state revenue; the personal income tax provided 31.8 percent; the corporate income tax provided 6.6 percent; excise taxes provided 16.7 percent; and a variety of other taxes, fees, and licenses provided the remaining 12.1 percent of state revenue (Gold, Smith & Lawton, 1995).

The income tax is widely used as a source of revenue by the individual states, with 41 of them levying an individual income tax in 1993. The exceptions were Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. New Hampshire and Tennessee *do* tax income from interest and dividends and Alaska and Florida tax corporate income. Most states that levy an individual income tax use federal adjusted gross income as the initial information needed to calculate the taxpayer's state income tax obligation. Adjustments then are made for certain items the state has chosen to treat differently, for example, capital gains or certain itemized deductions, to arrive at the state tax on income. A few states use federal net income and a few use the federal tax as the base for computing the state income tax. Consequently, a major change in the federal income tax will require the individual states to reconsider their own tax policies and practices.

State income tax rates tend to be low, seldom more than 10 percent at the high end, and most are either flat or slightly graduated. Thus, shifting to a single-rate flat tax would not represent a major change for most states. The more important question is how income would be defined for state tax purposes. The definition of income under the various flat tax proposals differs significantly from the definition used in the current federal tax system. Thus, states will have to decide whether to use the federal definition of income or to develop their own definition as well as their own income tax forms and procedures.

Clearly, the decisions states make on these issues will affect their stream of tax revenue. State aid to local school districts typically is paid from the general revenue of the state and *any decrease in a state's tax revenue might well be followed by a decrease in state school aid.* School districts would then have to either cut spending or turn to their only alternative revenue source, the property tax, at a time when voters are not enthusiastic about tax increases.

School District Bonds

The interest on bonds issued by school districts (and other municipalities) is exempt from the federal income tax. This feature makes municipal bonds attractive to taxpayers whose income is taxed at a high rate under the current federal tax system. A taxpayer paying at a high marginal tax rate, say 39.6 percent, can accept a lower interest rate and still come out ahead if the interest is exempt from the federal income tax. Consequently, the interest rate on bonds issued by school districts generally is lower than the interest rate on other bonds with comparable credit ratings. Under the flat tax proposals, all interest would be tax free, so logically we could expect that the interest rate on school bonds would be about the same as the rate on all other bonds with the same credit rating. School bonds would no longer enjoy their present tax advantage. The most likely result would be to increase debt service costs for districts that issue bonds. On the other hand, if interest income is not taxed, bond purchasers might settle for lower interest rates on all bonds. If so, school bond interest rates might be no higher than under the present system.

Property Tax Increases

Adoption of a flat tax could make taxpayers even more resistant to property tax increases, which are already unpopular with local taxpayers. For taxpayers who itemize deductions rather than taking the standard deduction, state and local taxes, including school taxes, can be applied to reduce the amount of their income subject to the federal income tax. Because the flat tax proposals provide only for a standard deduction with no additional deductions,

taxpayers might be reluctant to approve existing levels of property tax and even more reluctant to approve increases. And because the property tax is the only significant source of revenue at the local level, this could pose serious problems for local school boards and administrators.

Interest Rates and Property Values

Economists argue that investors seek a given "real" rate of return on their investment and that in evaluating an investment they factor into the expected rate of return such variables as inflation, taxes on property, interest payments, and maintenance costs. If interest is no longer taxed, then one variable that influences the cost of owning property will have changed drastically. Both interest rates and property values should decline because investors will be able to obtain the desired "real" rate of return at a lower cost. The cost incurred because of the tax on interest would no longer exist. The higher the investor's current income tax bracket, the greater the tax removed. The actual effect will depend on the supply and demand for property in a given geographic area at any time but, over time, interest rates could be expected to decline.

Attitudes Toward Home Ownership

A flat tax would also probably affect decisions of current and prospective homeowners. As noted, homeowners who itemize rather than take the standard deduction can claim both the property tax they pay on their home and the interest they pay on their mortgage as itemized deductions. The flat tax proposals provide only for a personal allowance with no additional deductions. The loss of the property tax and home mortgage interest as itemized deductions might effect the attractiveness of home ownership for some taxpayers. On the other hand, if property values decline because interest is no longer taxed, this might offset the loss of property tax and home mortgage interest as deductible items.

The indirect effect on property values of a flat tax on income are obviously of great interest and concern to school administrators and school board members because of their potential effect on local school revenues from the property tax. Unfortunately, estimating these effects with an educated guess is all that is possible given the lack of experience with a flat tax on income.

Local School Foundations

As school finances have become more constrained in recent years, many local school districts have established local school foundations as an additional

source of financial help. These foundations typically are non-profit organizations that solicit donations from individuals and businesses with the promise that the money will support projects in the local schools. Contributors can gain tax benefits by claiming the contributions as itemized deductions on their income tax returns. As we have discussed, no itemized deductions for charitable contributions would be allowed in a flat tax system, so the viability of local school foundations could be threatened—at least insofar as the contributor's donation is motivated by the promise of a tax break.

Investment in Human Capital

The various flat tax proposals give high priority to investment in physical capital—land, buildings, and equipment—by treating the entire amount of the investment as an expense in the year it is made. What is not clear is whether investments in human capital will be treated in the same way. Research over the past 35 years by economists has demonstrated that investment in education is an effective way to enhance human productivity (Becker, 1975; Cohn and Geske, 1990). In fact, the rates of return to investment in human capital have often exceeded the rates of return to investment in physical capital. Estimates of the rate of return to investment in secondary schooling typically range from 15 to 25 percent and those for four years of college education range from 10 to 15 percent (Cohn & Geske, p. 105-110). Clearly, investment in education and training should receive the same tax treatment as investment in physical capital. If investments in physical capital are to be written off as they are made, then investments in education or training also should be eligible for immediate write-offs. The flat tax proposals have not dealt adequately with how investment in human capital would be treated.

Educators need to think seriously about the consequences that could flow from the tax treatment accorded investment in education. For example, if all investments in schooling are given the same tax treatment as investments in physical capital, *private schools could become much more attractive because tuition payments could immediately be written off as an investment*. Because democratic self-government depends on a literate electorate, policymakers need to consider whether elementary schooling should be provided for all children at public expense and not qualify as a private investment? At what level of education should investment in education qualify for immediate write-off—secondary school, college or graduate school? And how would the tax treatment accorded investments in education affect recent initiatives to expand school choice (e.g., charter schools and vouchers)?

Conclusion

Proposals for reform of the federal income tax will almost certainly continue to play a prominent role in national political debate. Because several influential members of Congress are strong supporters of the flat tax, it will continue to command attention.

Virtually any change in federal tax policy has both direct and indirect implications for school funding. Unless school administrators are actively involved in the debate, the interests of America's school children will be at risk. Consequently, school administrators need to:

- Keep well informed about the pros and cons of the flat tax (and any other proposals for federal tax reform),
- Point out to local, state, and federal policymakers the implications of such proposals for the financing of our public schools, and
- Argue persuasively for provisions that will protect the flow of revenue to public schools and our investment in tomorrow's leaders—America's students!

References

Arthur D. Little, Inc. *Development of Methodology for Estimating the Taxpayer Paperwork Burden.* Washington, D.C.: Internal Revenue Service. 1988.

Becker, G. S. *Human Capital* (2nd ed.). Chicago, Ill.: University of Chicago Press. 1975.

Cohn, E. and Geske, T. G. *The Economics of Education* (3rd ed.). Oxford, England: Pergamon Press. 1990.

Friedman, Milton. *Capitalism and Freedom.* Chicago, Ill.: University of Chicago Press. 1962.

Gold, S. D., Smith, D. M., and Lawton, S. B. *Public School Finance Programs of the United States and Canada, 1993-94.* Albany, N.Y.: Center for the Study of the States, Rockefeller Institute of Government. 1995.

Hall, Robert E. and Rabushka, Alvin. *The Flat Tax* (2nd ed.). Stanford, Calif.: Hoover Institution Press. 1995.

National Center for Education Statistics. *Digest of Education Statistics.* Washington, D.C.: National Center for Education Statistics. 1995.

Payne, James L. *Costly Returns: The Burdens of the U. S. Tax System.* San Francisco, Calif.: Institute for Contemporary Studies Press. 1993.

Peckman, Joseph A. *Federal Tax Policy* (4th ed.). Washington, D.C.: Brookings Institution. 1983.

Penniman, Clara. *State Income Taxation.* Baltimore, Md.: Johns Hopkins University Press. 1980.

Reynolds, Alan. Tax rates rise and fall—but revenues stay the same. *Hudson Policy Bulletin*, No. 19. (February 1996), pp. 1-2.

Smith, Adam. *The Wealth of Nations*. Edwin Cannan (Ed.). Chicago, Ill.: University of Chicago Press. 1976.

Staff. America's Tax Reform: A Better Way to Pay. *The Economist*. January 13, 1996. pp. 32-34.

Witte, John F. *The Politics and Development of the Federal Income Tax*. Madison, Wis.: University of Wisconsin Press. 1985.

Related titles available at a discount to AASA members through the AASA Distribution Center include:

Telling the Truth About America's Public Schools
Kristen Amundson
1996; 20 pages; softcover; ISBN 0-87652-224-X
AASA Stock #580

Private School Vouchers: What are the Real Choices
Nancy Kober
1996; 64 pages; softcover; ISBN 0-87652-225-8
AASA Stock #586

The Manufactured Crisis: Myths, Fraud, and the Attack on America's Public Schools
David C. Berliner and Bruce J. Biddle
1995; 432 pages; hardcover; ISBN 0-201-40-40957-7
AASA stock #529

Exploding the Myths: Another Round in the Education Debate
Paul D. Houston and E. Joseph Schneider
1993; 103 pages; softcover; ISBN 0-87652-186-3
AASA Stock #205

Preparing Students for the 21st Century
Donna Uchida, with Marvin Cetron and Floretta McKenzie
1996; 74 pages; softcover; ISBN 0-87652-193-6
AASA Stock #528

Toll-free call—1.888.PUB.AASA [1.888.782.2272],
or Toll call—1.301.617.7802
8:30 a.m. - 5:00 p.m. est, Monday through Friday
for member and nonmember pricing
or to place an order for
additional copies of this publication,
or other publications.

AMERICAN ASSOCIATION OF SCHOOL ADMINISTRATORS
1801 North Moore Street
Arlington, VA 22209
(703) 875-0748
http://www.aasa.org